

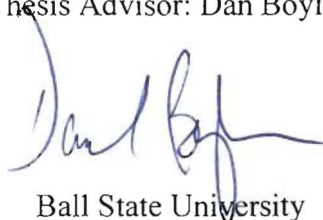
The Effects of Sarbanes Oxley on Publically Traded Companies

An Honors Thesis (HONR 499)

By

Emily Chase

Thesis Advisor: Dan Boylan

A handwritten signature in blue ink, appearing to read "Dan Boylan", is positioned above the text "Ball State University".

Ball State University

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Abstract

Sarbanes-Oxley (SOX) has been in place for over a decade, and the effects of the legislation are widely debated in the business community. To determine whether SOX has affected publically traded companies in the United States a number of components have to be examined. SOX has decreased the number of discretionary accruals performed by CEOs/CFOs and increased the quality of internal controls. Also important when discussing the effects of SOX are backdating stock options and material weaknesses, which declined significantly for implicated companies in the post-SOX era. Non-implicated companies did not experience such a decline. For the most part companies that reported aggressively prior to SOX are impacted more than their conservative counterparts.

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My thesis project is about the effectiveness of the Sarbanes-Oxley Act as it pertains to the revenue recognition policies of publically traded companies. This is important to anyone with investments in publically traded companies because it reinforces the reliability of company's financial statements and reported individual return on investments. The implications of SOX also extend to CEO/CFOs, individuals employed in accounting and financial fields, lawmakers and the individuals and agencies who enforce the regulations. The below definitions will provide the necessary basic understanding of the terminology used in my thesis.

Definitions

Aggressive - The practice of misreporting income statement and balance sheet items to make a company appear more attractive to investors. Although some forms of aggressive accounting are illegal, others are not. Regardless of the legality, however, aggressive accounting practices are universally frowned upon, as they are clearly designed to deceive. Aggressive accounting is also known as "creative" or "innovative" accounting and in the worst, most fraudulent cases, is referred to as "cooking the books." (Aggressive)

Backdating - Dating any document by a date earlier than the one on which the document was originally drawn up. Under most circumstances, backdating is seen as fraudulent and illegal, although there are some situations in which backdating can be used in a legal and beneficial way, such as backdating a claim for a past period (Backdating)

Conservatism principle - accounting for a business should be fair and reasonable. Accountants are required in their work to make evaluations and estimates, to deliver opinions, and to select procedures. They should do so in a way that neither overstates nor understates the affairs of the business or the results of operation (Conservatism)

Discretionary accruals - a non-mandatory expense/asset that is recorded within the accounting system that has yet to be realized; ie. management bonus (Discretionary)

Corporate governance - the system by which business corporations are directed and controlled.

The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.

By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance (Corporate)

Financial reporting framework - a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (Financial)

Income smoothing - measures taken to reduce the probability of income shocks before they occur, and includes strategies like diversifying income sources; making low-risk production and employment choices; building up physical, human, and social assets; and ensuring good financial management (Income)

Internal controls - include policies and procedures that (a) pertain to the maintenance of accurate and reasonably detailed records, (b) provide reasonable assurance that transactions are properly recorded and authorized, and (c) safeguard assets (Internal)

Generally Accepted Accounting Principles (GAAP) - a recognized common set of accounting principles, standards, and procedures. GAAP is a combination of accepted methods of doing accounting and policy board set authoritative standards (Generally)

Material weakness - a condition that could potentially result in the material misstatement of the financial statements (Material)

Sarbanes-Oxley Act (SOX) - contains sweeping reforms for issuers of publicly traded securities, auditors, corporate board members, and lawyers. It adopts tough new provisions intended to deter and punish corporate and accounting fraud and corruption, threatening severe penalties for wrongdoers, and protecting the interests of workers and shareholders. The Sarbanes-Oxley Act of 2002, was signed into law by US President George W. Bush and became effective on July 30, 2002 (Sarbanes)

Shareholders - an individual or company, (including corporations) that legally owns one or more shares of a company (Shareholders)

Stakeholders - a person, group, organization, or system who affects or can be affected by an organization's actions, e.g. stockholders, employees, vendors, and customers (Stakeholders)

Definitions References

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The Sarbanes-Oxley Act (SOX) was put into effect in 2002, and since then its effectiveness has been debated by many in the business community. Those who oppose SOX believe the added work and financial costs far outweigh any of the possible benefits. Supporters of SOX believe that the additional work and costs are worth the increased quality of financial statements and the peace of mind of the many stakeholders. Since SOX has been in effect for over a decade, it is possible to see the long term effects of the act. The revenue recognition of aggressively reporting companies prior to SOX have been effect more so than their conservative counterparts.

SOX was created as a reaction to corrupt corporate scandals that occurred during the late 1990s and early 2000s, which include WorldCom and Enron (Anand, 3-4). As a result of the many corporate scandals that occurred many investors, and the public had lost trust in the American markets and its companies. Many shareholders had been deceived as to the true financial state of the companies they had invested money in, and the shareholders lost their investments when the corporate scandals came to light. SOX is named after the two men who brought the Act about, Senator Paul Sarbanes and Congressman Michael Oxley. The two men and both houses of Congress worked to create an act that would hold publically traded companies to higher standards and require more transparent financial reporting methods (Anand, 18)

SOX was written following three principles: integrity, accuracy, and accountability. These three principles are reflected in the legal requirements of the act (Anand, 23). When a company is said to comply with SOX it is meant that the company has taken the necessary steps to assure the public of the accuracy of its financial reports. This is meant to reassure the investors that the information issued by the company is valid and truthful. SOX requires that

companies establish an accounting framework that includes internal controls to insure accurate financial reporting practices (Anand, 28-29). SOX also requires that the CEO/CFO of a publically traded company must sign off on the accuracy of the issued financial statements. The penalty for SOX noncompliance can include civil lawsuits, and CEOs/CFOs are subject to financial penalties and incarceration (Anand, 34)

The majority of corporate scandals involved companies that aggressively applied generally accepted accounting principles (GAAP). Since SOX has been in place there has been an almost immediate recognizable increase in conservatism in financial reporting. This increase in conservatism can be measured in the decrease in discretionary accruals, and the change in loss and gain recognition practices (Lobo, G. J., Zhou, J. (2006), 57).

Premature revenue recognition is a kind of aggressive earnings management that was practiced in over a third of the 919 financial restatements announced in the five year period prior to the enactment of SOX. In the early 1990s companies were known to save excessive revenues in rainy-day funds. These funds were used to smooth out earnings in years where companies performed poorly. Income smoothing turned into a darker practice in the late 1990s when companies reported revenue that would be earned in future financial periods. The penalties that can be levied against CEOs/CFOs since the implication of SOX have discouraged CEOs/CFOs from using their power to overstate earnings, and encouraged them to be more conservative when reporting financial information. Essential CEOs/CFOs are encouraged to report conservative numbers to protect themselves from potential legal prosecution. Part of reporting conservative numbers includes reporting losses when they become evident, but only incorporating gains after they have been realized and collected (Lobo, G. J., Zhou, J. (2006), 57-58).

Risk adverse CEOs/CFOs are more likely to report lower earnings by reducing discretionary accruals after the implementation of SOX. To prove this fact the discretionary accruals from a collection of Canadian companies listed on both the Canadian and U.S. stock exchanges were compared to a control group of companies listed on just the Canadian stock exchange. The two years prior to and after the implementation of SOX were used in this comparison. There was a significant decrease in signed discretionary accruals in the post-SOX period when compared to the pre-SOX period for companies listed on both stock exchanges. The companies listed on just the Canadian exchange showed no discernible difference between pre- and post-SOX periods. This shows that companies required to follow SOX have decreased the number of discretionary accruals, which is an indication of an increase in accounting conservatism. Since the companies listed on just the Canadian stock exchange did not experience a decrease in signed discretionary accruals, the increase in conservatism can be contributed directly to the implementation of SOX (Lobo, G. J., Zhou, J. (2009), 2).

Backdating stock options is a practice that retroactively adjusts stock option grant dates to lower the exercise price. It is a practice that has raised governance, legal, accounting, tax, and auditing concerns. Backdating is believed to be the result of ineffective corporate governance and management opportunism; both factors have been linked to higher levels of discretionary accruals. When companies that are implicated in the practice of backdating stock options are compared to non-implicated companies, implicated companies had more discretionary accruals in the pre-SOX era than non-implicated companies. The effect of SOX is much greater on the implicated companies, than the non-implicated companies (Hossain, 279).

Along with increasing the quality and accuracy of financial reporting, SOX also increased the quality of internal controls in publically traded companies. There is a strong

correlation between the quality of internal controls and accounting conservatism. A study comparing companies with material weaknesses to companies without them discovered a correlation between internal controls and accounting conservatism (Goh, 2-4). Companies that disclose material weaknesses are less conservative compared to companies without material weaknesses. Companies that correct material weaknesses are more conservative than companies that fail to correct their material weaknesses. Companies that report material weaknesses are more conservative after reporting such weaknesses, whether or not the weaknesses are corrected. The results of the study suggest that the internal control requirements of SOX have encouraged companies to report more conservatively, which can be attributed to the higher risk of lawsuits due to material weaknesses in internal controls. Accounting conservatism is accomplished more thoroughly with strong internal controls, which are required by SOX (Goh, 27).

Through multiple studies focusing on various facets of accounting – discretionary accruals, backdating stock options, and internal controls – it is obvious that SOX has had an impact in the financial reporting of publically traded companies. Companies that reported conservatively prior to the implementation of SOX continued to report conservatively in the post-SOX era. Companies that were more aggressive in their financial reporting were greatly impacted in the post-SOX era.

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